Driving a sustainable digital assets strategy

Digital assets continue to drive pivotal change in the financial services space

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Driving a sustainable digital assets strategy

The digital assets space looks vastly different today than it did just a few years ago.

While the field has become more crowded, some assets and their associated companies have also experienced high-profile declines. Digitally native companies that custody digital assets or have platforms for the trading of such assets—whether cryptocurrencies such as Bitcoin and Ether, non-fungible tokens, stablecoins, or security tokens—need to be able to adapt their vision and strategy as the landscape changes.

Companies need to have a clear understanding of where they fit into the broader landscape, especially given growth in the space in recent years. To drive a sustainable digital assets strategy in this environment, companies need to understand the regulatory conversation. This is especially important given potential counterparty risks and potential implications that the declines of some organizations could have for the rest of the sector.

Along with a clear strategy and a comprehensive regulatory understanding, companies in the digital asset space need to have a way to assess what the shifting landscape means for their technology systems and processes, digital asset security, audit and accounting, and tax functions, systems and processes. This e-book examines important considerations in each of these areas.

> A lot of companies over the years have had a poor value proposition for why they were issuing digital assets, or they have had poor operational controls to manage custody of digital assets, both of which have led to their abandonment or collapse.
>
> **BENNETT MOORE**, National Leader, Blockchain and Digital Assets Center of Excellence, RSM US LLP

OPERATIONS AND STRATEGY:

Be ready to pivot

> The question is, how do you build despite regulatory uncertainty and have the agility to adapt to constantly changing regulations?

JAY SCHULMAN, Blockchain and Digital Assets Practice Leader, RSM US LLP

Companies' trajectories with digital assets often fall into one of two camps: the "move fast, break things" segment and the "slowly, then all at once" segment.

Some organizations make rapid progress in growing their product offerings or customer base before fully assessing how anticipated regulatory changes for digital assets will affect their performance down the road. Others might spend longer honing their strategy and find that in the meantime competitors have announced new services that will significantly disrupt their plans.

To be adaptable, companies need to foster a culture of innovation, be set up to pilot potential new products and service offerings, be able to pivot based on what they learn, and understand how to manage risk.

There are a range of strategy and operational considerations companies need to weigh depending on whether they offer custodial services or provide a platform for people to use cryptocurrencies or other digital assets.

> Like it or not, for digitally native companies to do business with large institutions, they will need to provide a level of transparency to their customers and comply with many of the same rules and regulations as traditional finance.
>
> **MATT GILL**, Partner, Financial Services Risk and Controls, RSM US LLP

For some companies, it may make sense to work toward having the flexibility to offer custody for as many different types of digital assets as possible. Some key aspects of the business that can enable this flexibility include:

Operational flows and controls:

The controls in place for digital assets can differ significantly from what companies are used to, even at the basic level of moving digital assets.

Back-office integration:

Because the technology at a digitally native company is so integrated into financial services, the back office can't be an afterthought. The finance team should also be tightly connected to the product.

Infrastructure preparedness:

To achieve longevity, financial services companies in this space need to understand the larger structural changes blockchain is driving.

As more banks and other traditional financial institutions are looking to grow their cryptocurrency offerings, it's especially important for digitally native companies to hone their strategy and operations to remain competitive and resilient.

RISK AND SECURITY

Companies focused on digital assets face the same risks as many other financial services organizations, but to a heightened degree. There are three key areas of risk for leadership teams to understand and assess:

Security risk

Digital asset transactions are irreversible; if, for example, an unscrupulous employee or another malicious party transfers digital assets into their own wallet, there is almost nothing the company can do to get them back, at least on a technical level.

Mitigating the risk of theft or internal collusion comes down to strong internal controls in four key areas:

1. Secure generation of private keys
2. Segregated access management
3. Physical and virtual security of critical components to access digital asset wallets
4. Incident response and business continuity plans for events

Custody architectures for digital assets can vary, but primarily include two types of storage: hot storage and cold storage, each carrying different security and operational risks.

Third-party risk

Risk from third parties is unique in the digital assets space because of how unknown and immature many of the entities still are. For instance, it's vastly different from selecting Amazon, a household name, to be your provider of cloud services. Vendors in the digital-assets realm could be a two-employee company situated anywhere in the world.

Regulatory risk

Given the evolving landscape, there is still debate in the United States around which body or agency is the primary regulator of digital assets—whether the Commodity Futures Trading Commission, the U.S. Securities and Exchange Commission, the Federal Reserve or other banking regulators. Having an external party to provide guidance from a regulatory compliance perspective can be crucial in helping companies keep up with the impact of rapid change on everything from accounting and taxes to client onboarding as it relates to know-your-customer and anti-money laundering (AML) standards.

> There are a lot of small service providers that have popped up in this space, some credible, others not. There are a lot of technical aspects to that ecosystem, and most organizations in this space are using service organizations for things such as custodians, fund administrators, transaction monitoring and wallet providers. There are a lot of options, so vendor due diligence is critical.
>
> **MATT GILL**, Partner, Financial Services Risk and Controls, RSM US LLP

For companies that have the ethos of a startup, leadership teams might want to focus on getting a product to market first and worry about risks—regulatory and otherwise—down the line. But the wiser move is to address those risks on the front end, and establish how those risks differ between digital assets and traditional financial assets.

"There is a lot of reputational, financial and operational risk that you are taking on by strictly moving fast without guidance regarding what is coming down the regulatory pipeline," says Gill. "Those things need to be a part of both your business strategy and risk assessment."

One of the most important ways organizations can mitigate risk is to have resilient security protocols in place that consider the new, blockchain-based infrastructure of the digital assets space.

"What's happening here is we are moving all forms of value and data—from financial and social systems—and putting them onto a new architecture that can exist with improved transparency, security, incentive mechanisms and automation," says Moore. Because of the blockchain's transparency, IT security and cybersecurity as they relate to custody of these digital assets are crucial.

A third-party advisor can help with various parts of such a risk assessment, including:

Risk assessment framework

Developing the risk assessment framework considering the organization's current and strategic states

Organizational risk

Identifying the organization's financial, operational, regulatory and technology risks

Assessing controls

Assessing the strength of the organization's control environment and assisting with enhancing or developing controls to mitigate identified risks

Improving controls

Advising on how to adjust the organization's control environment based on changes in risks

REGULATORY AND COMPLIANCE

Working within the regulatory framework that would apply to a bank or a broker-dealer might seem unappealing to fast-moving digitally native companies, but it will likely be beneficial in the long run.

Doing something incorrectly and having to unravel it will usually be much more costly—and carry more risks, reputational and otherwise—than having the right strategy and approach from day one. Some key parts of the regulatory and compliance landscape include:

Evolving federal and state rules:

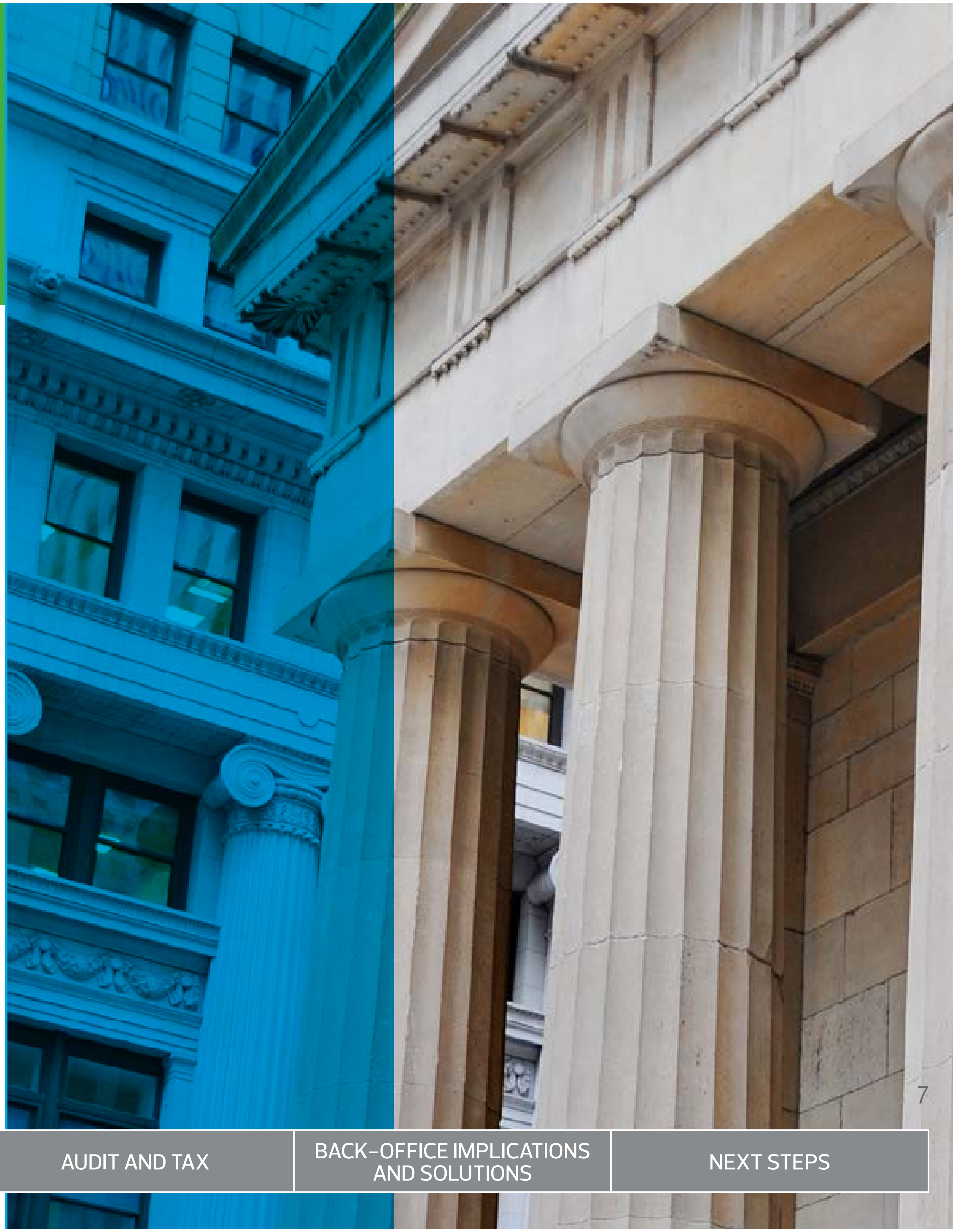
SEC chair Gary Gensler has signaled the agency's intent to regulate cryptocurrencies. The acting chair of the U.S. Federal Deposit Insurance Corp. has similarly noted that the risks posed by crypto-assets require that the agency prioritize regulation of such assets. In 2022, the acting comptroller of the currency, Michael J. Hsu, noted that crypto has gone mainstream and will require a "coordinated and collaborative regulatory approach." In late 2022, the New York Department of Financial Services also signaled increased regulations for cryptocurrency companies operating in the state.

AML and know-your-customer compliance:

Traditional AML financial crimes software and the software that is designed to identify bad actors/wallets in the digital assets space are currently disparate systems. A company's ability to synthesize those systems together comes down to its compliance team understanding how those systems work and how to trace cryptocurrency.

Insurance:

It's important to remember that custodians' insurance has many exemptions. Many types of insurance only cover certain types of custody architectures and certain types of losses, and companies need a thorough understanding of its limitations.



Because of the decentralized, borderless nature of blockchain and digital assets, many companies may find it necessary to operate globally. But there are also a number of global compliance implications to consider. Here are just a few:

Central banks have not yet solidified how they will regulate digital assets but are also considering central bank digital currencies.

Many digital companies may have teams that sit in locales around the world but haven't yet decided where their official headquarters is. That decision will determine a lot in terms of tax strategy, audit compliance and broader business operational issues.

Companies need to decide where their target markets are; while the United States may be viewed as stricter in terms of regulations compared to other countries, its financial services ecosystem is enormous.

AUDIT AND TAX:
Layers of complexity

As the use of digital assets proliferates and regulatory bodies continue to chart new territory, auditing and accounting for those assets present fresh challenges.

Many cases involving distributed ledgers and cryptocurrencies require thoughtful examination of basic considerations within traditional audit and accounting frameworks, while other instances call for new standards and practices.

The IRS, SEC, American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board and others are at various stages of issuing regulation and guidance on digital assets. But at this relatively early stage, uncertainty lingers around some elemental issues, such as which rules to follow, the jurisdiction of regulators and even the nomenclature by which to refer to such assets.

In the absence of definitive answers to questions about auditing, accounting and taxation of digital assets, understanding these new challenges and adapting to them is essential.

There are all types of implications throughout revenue streams, and it adds layers of complexity around accounting that are traditionally not there. Existing accounting software doesn't really accommodate it, but providers are starting to help with all of this.

TODD BRIGGS, North America Digital Assets Audit Leader, RSM US LLP

Important issues to consider

AUDIT

Reliability and relevance of the ledger: A ledger, such as a blockchain, might include information that is internal or external to the entity being audited. Auditors will judge the ledger's relevance and reliability, examining what information goes into the blockchain and how transactions are processed.

Rights and custody: An auditor must carry out certain procedures to determine an entity's ownership, rights and obligations over a wallet address and assets held under custody. The entity that is under audit needs to provide sufficient and appropriate evidence that they have the right to control or move the assets in the wallet.

Off-chain support: Auditors need to understand if there is a manual process between information flowing from the blockchain into the financial statements, and what that process looks like, and if it is subject to human error or fraud.

ACCOUNTING

Measurement basis: The AICPA's digital asset working group published a practice aid in 2019 explaining that digital assets should be classified as indefinite-life intangibles (note the AICPA updates the practice aid on a continuing basis). That means the digital assets should be recorded at their initial fair value but not adjusted to fair value thereafter. Instead, the digital assets will be tested for impairment.

Revenue accounting: If a company purchases a tangible good from another company in exchange for a digital asset, and if it is assumed the transaction is within the scope of Accounting Standards Codification 606, the fair value of non-cash consideration would likely be the asset's fair value as measured as of the contract inception date. That value will be used to record the revenue recognized upon transfer of the goods.

Tax implications: The IRS classification of digital assets as general property creates different tax results in terms of gain or loss for a taxpayer. Whether a digital asset is exchanged for a durable good or used to pay network fees, the taxpayer will generally have a taxable event and record gain or loss on each transaction. However, there is uncertainty about when a taxpayer might recognize income with respect to digital assets awarded for helping to maintain a blockchain.

OTHER KEY AREAS

Human capital: The evolving audit and tax landscape requires unique skill sets that are not inherent in more traditional finance organizations. Because it can be difficult for companies to keep pace with fostering this type of talent in-house, hiring specialists can help the back office keep up with the front office.

System and organization controls reports: SOC I and II reports provide greater transparency, build trust with your customers and prospects, and make reporting more efficient.

Readiness assessments: A tax and accounting readiness assessment can help identify critical issues a company would need to address depending on how accounting regulations shake out.

Tax structuring: Given that many digital asset companies are multinational, entity structures can be complex, especially because digital assets have depreciable and non-depreciable components. A third party can help with planning related to tax liabilities.

BACK-OFFICE IMPLICATIONS AND SOLUTIONS

While leadership teams at digitally native companies understand their digital assets product offerings and how this space has evolved over the years, such businesses typically operate in a fast-paced environment with limited resources to grow their accounting or other back-office functions as they scale up.

Dedicating time to build out the back office and ultimately your financial reporting framework is crucial. If ignored, it can become much harder to unravel down the line, especially from a systems perspective, when you're working with high volumes of on-chain data. One of the biggest benefits of prioritizing backoffice functionality of this is scalability and flexibility to plan for future success.

ELIZABETH HART, Technical Accounting Consulting Partner, RSM US LLP

Even when these companies raise capital quickly, they typically invest it into key products or strategic initiatives.

Nevertheless, leadership teams need to understand how various back-office functions are affected by what's happening on the accounting, finance and regulatory front.

For companies seeking to create a sustainable digital assets strategy, they shouldn't view these aspects of the business as something to address down the line; in order to raise funds and get venture capital investment, interested parties will want to see your revenue, your balance sheet and your service providers.

With so many competing needs, though, it may be difficult to figure out where to start to develop best practices for reporting, technology and operations. Working with a third-party advisor can help companies navigate a host of critical back-office issues pertaining to digital assets, including:

- Developing technical accounting policies to increase financial reporting functionality and visibility into real-time performance
- Explaining key areas of consideration such as revenue recognition, custody and balance sheet presentation, valuation policies, and evaluation of a principal market
- Understanding the evolving and newly released guidance, such as *Staff Accounting Bulletin No. 121*, which the SEC released in March 2022
- Advising on technology and systems to track digital assets for accounting and tax purposes, including considering a third-party tool to assist with these often-challenging calculations

NEXT STEPS

There is a lot to consider when driving a sustainable digital assets strategy. Here are some next steps to help you keep going:

Contact our digital assets professionals on next steps for driving your digital assets strategy forward.

CONTACT US

EVOLVE OPERATIONAL CONTROLS:
Teams should regularly revisit operational flows to ensure they are keeping up with the evolving landscape.

ASK THE RIGHT QUESTIONS:
Especially on the audit and tax front, companies should ask questions early and often about how to apply various standards.

ASSESS RISKS:
An external advisor can help you develop a risk assessment framework for security, third-party, regulatory and other risks.

GET YOUR BACK OFFICE READY:
Don't delay in building out your company's back-office functionality. Consider working with an advisor to assess potential solutions.

KEEP PACE WITH REGULATORY CHANGE:
A trusted third party can also help you navigate evolving federal, state and global rules.

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